# Putting *Cost* Back Into Pricing

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Competitive pricing is always a hot button with business owners. They know competitive prices will attract customers. They also know that price is usually one of the first pieces of information buyers' collect. If they can make a favorable first impression, they feel increased sales and loyal customers will follow.

The downside of competitive pricing is that many business owners establish prices without analyzing their costs. They simply use their competitor's price as a benchmark and make the assumption that it will cover costs and provide a margin for profit. Unfortunately, this assumption is seldom correct, especially if they choose to price themselves below the competition, which is quite common. Everybody's costs and profit margins are different and what may be acceptable for one business, may result in a loss for another. Often, business owners will say, "I'll raise my prices later, after I have customers," or "I'll make up for lower prices with volume." Most of the time, this does not work because of market factors.

Business owners need to have a good understanding of their business expenses and how these expenses impact the overall pricing structure of their business. Most owners understand the cost of individual items but many lack a methodology that insures all these costs are captured in their selling price. They encounter difficulty when they try to factor overhead items such as indirect labor, interest, rent, and utilities into a their price. These costs are not easily attributable to a particular product or service and often one or more is overlooked.

A preferred method of capturing costs is to calculate an overhead percentage. The overhead percentage provides an easy way to factor overhead expenses into a selling price and a convenient way to monitor the impact changing costs have on prices. It provides the business owner with a means to allocate overhead expenses proportionately to the direct labor dollars billed to each customer. Although the overhead percentage formula is simple to use, divide overhead expenses by direct labor; it requires an understanding of pricing terminology and a working knowledge of the process for calculating it.

## Pricing terminology

In order to calculate an overhead percentage, business owners should become familiar with the terminology used in the overhead percentage formula. The terms differentiate between billable (income producing) and non-billable (non-income producing) activities and assist in categorizing costs used to estimate the percentage. The important terms to remember are:

- Business expenses: *all expenses* found on the Income Statement (also called the Profit and Loss Statement).
- Overhead expenses: all *costs* found on the income statement *except for direct labor, direct materials, and costs attributable to outside subcontractors that can be billed directly to a customer's account*. Overhead expenses are absorbed by the business and factored into the selling price as a percentage of the direct labor cost. They include indirect costs such as accounting, advertising, depreciation, indirect labor, insurance, interest, legal fees, rent, repairs, supplies, taxes, telephone, travel, and utilities.
- Direct labor: labor used to produce products and services purchased by customers. These man-hours are directly attributable to customer activity.
- Indirect labor: labor used to provide supporting services to the business such as accounting, clerical, custodial, customer services, management, purchasing, sales, and warehousing. These man-hours support business functions but are not directly chargeable to the customer.
- Direct materials: materials used in the final product or service purchased by customers. These materials are charged directly to the customer's account.
- Overhead percentage: ratio between direct labor and overhead expenses. This percentage is used to allocate overhead expenses proportionately to direct labor dollars billed customers.

## Calculating the overhead percentage

The overhead percentage is calculated using a seven-step process. The steps are listed below:

Step 1: Determine "average" hourly wage paid to direct labor employees - classify each employee's contribution or portion thereof, as either direct or indirect labor. Determine the hourly wage rate paid to each direct labor employee including the business owner if applicable. Total the hourly wage rates and divide by the number of employees counted.

Step 2: Estimate direct labor workdays available in the calendar year - calculate the number of direct labor workdays in a calendar year by subtracting the average number of days that direct labor employees will not be present for work because of weekends, holidays, vacations and miscellaneous (e.g. injury, personal, sickness, etc). Count only direct labor employees. Do not include any indirect labor employees in this estimate.

Step 3: Estimate billable direct labor hours for work year - multiply available direct labor workdays by the scheduled 8-hour workday minus the average number of *daily* non-billable direct labor hours. Non-billable direct labor hours include lunches, breaks, company meetings, training, cleanup, etc. that a customer will not pay for directly.

Step 4: Estimate billable direct labor dollars for work year - multiply billable direct labor hours by average direct labor wage.

Step 5: Estimate non-billable direct labor dollars for work year - subtract billable hours from the total man-hours available in a work year, which is 2088 hours. The remainder equals the non-billable direct labor hours. Multiply this number by the average direct labor rate to arrive at the non-billable direct labor dollars. These costs are absorbed by the company and must be passed on to the customer in the overhead percentage.

Step 6: Estimate all overhead expenses for work year to include non-billable direct labor - Refer to actual or proforma income statement, total all the business expenses shown. Deduct the cost of billable direct labor, direct materials, and costs attributable to outside subcontractors that can be billed directly to a customer's account. Do not deduct the cost of non-billable direct labor. Adjust total for inflation and projected price changes that will occur in labor and materials for the coming year.

Step 7: Calculate the annual overhead percentage - divide the overhead expense (Step 6) by the billable direct labor dollars (Step 4).

## Using the overhead percentage

Calculating a selling price is a simple process once the overhead percentage has been determined. However, most business owners are not prepared for the results they see. Their reaction is usually one of surprise and disbelief when they realize the impact this percentage has on their selling price. They are often heard to say, "I couldn't charge those prices if I wanted too!" This may be true, especially if their customers are price sensitive, but the alternative may mean a business failure. Success and profitability demand that costs be factored into the selling price. The overhead percentage gives the business owner an opportunity to analyze business expenses and determine whether or not non-competitive pricing strategies should be the main competitive focus.

After computing the overhead percentage, each of the assumptions made in projecting direct labor and overhead expenses should be re-visited. This will allow changes to be made and will help formalize the process of calculating an overhead percentage. Business owners are always very curious about this process and find the information extremely helpful. As each step is calculated, they begin to visualize the larger pricing picture and actually see the impact that everyday business decisions have on their selling prices.